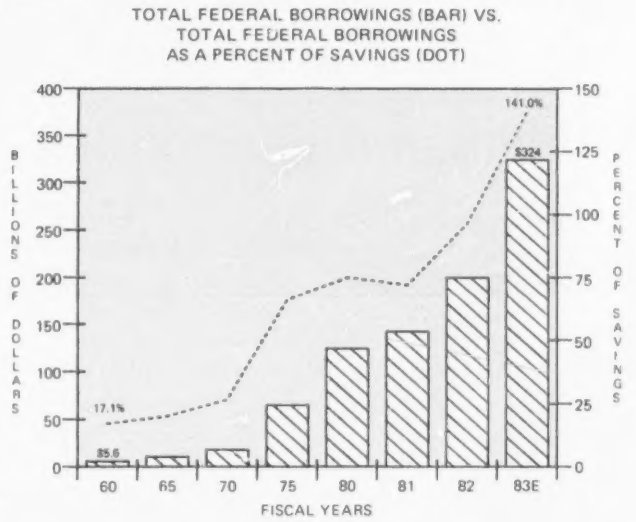
than the growth of goods and services. In order to curb inflation, we will need to slow the growth in our money supply."

After they were in office and the economy showed little signs of improvement, the Administration's economic team suggested that it would be the passage of what came to be known as the Kemp-Roth tax cut that would get the economy moving again. In March 1981, President Reagan declared that such a cut in taxes, when passed, would produce "an immediate impact on the economic vitality of the nation." As you well know by now, even as the bill became law in August 1981, the economy was slipping into one of the worst recessions of the postwar era.

The tax cut was supposed to do other things as well. It was billed as generating enough extra revenues to pay for an increase in defense spending and still balance the budget by fiscal year 1984. We got the increase in defense spending (and nondefense spending as well), since federal budget outlays went from 22.9 percent of GNP in 1980 to 25.6 percent in 1983, according to the Treasury Department. Unfortunately, we did not get the surge in revenues that the Administration expected. Receipts as a percent of GNP, reports the Treasury, were 20.1 percent in 1980—and only 18.6 percent in 1983. Nor are we likely to get these revenues in the foreseeable future. The Office of Management and Budget estimates that the Economic Recovery Tax Act of 1981, generating progressively larger annual losses in revenues, will cost the government $627 billion in tax revenues between 1982 and 1986. This is about four-fifths of the $785 billion cumulative deficit that the Administration now believes it will run during this time!

Needless to say, we do not have a balanced budget. Indeed, the budget deficit grew from $59.6 billion in 1980 to $110.6 billion in 1982 and in the fiscal year ended September 30, 1983 reached a whopping $195½ billion. Whether you look at this in terms of the deficit as a percentage of GNP, or, as we prefer to do, total Federal borrowing requirements compared with the amount of net savings available in the economy, it is clear that we are in uncharted territory. The financial markets have reacted to this by keeping interest rates high even though the rate of inflation slowed. They fear that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving up interest rates in the process —or that they would not; that the Federal Reserve would monetize these deficits, but in the process, set the stage for a new round of inflation.

Not surprisingly, in view of these high interest rates, another supply-side promise failed to come true. This was the positive impact on business investment that the tax cut was supposed to generate. Capital spending began falling immediately after the bill's enactment, leading to the first two-year decline in such outlays



since the end of World War II. And while capital spending is picking up now, most of the rise seems to be attributable to business spending on equipment for purposes of modernization to cut costs, rather than on such major capital goods as factories, office buildings, shopping centers and the like which would increase the capacity of industry to produce and compete more effectively with other countries.

Savings Are Down . . .

Another thing the supply-side program did not do was encourage savings. This has to be a major disappointment for these advocates, since a large part of the Administration's program was targeted on this objective. For example, the tax cuts were skewed toward the middle and upper income brackets. In addition, legislation was passed allowing the banks to offer All Savers certificates, which enabled people to earn a substantial amount of interest from a bank deposit free of Federal taxes. There was also an expansion of individual retirement accounts (IRAs) and Keogh plans which, it was thought, would further induce people to save. No doubt many people have taken advantage of these plans. However, most seemed to have done so—not by saving new money, but rather, by shifting savings from other accounts. From 6.6 percent annually in 1981, personal savings as a percent of take home pay fell to 5.8 percent in 1982, and to only four percent in the second quarter of 1983—the lowest quarterly rate in 33 years

—before rising to 4.7 percent in the third quarter. In the context of the Federal governments's borrowing needs which, as noted earlier, have grown tremendously, this reduced rate of savings obviously means less money available for others to tap such as home builders, small businessmen, and consumers who need to borrow in order to make major purchases.

On another note, supply-side economics has not caused people to abandon tax shelters. Although measuring tax shelter activity is difficult and there is no formal definition of just which of a vast array of tax-favored activities should be regarded as shelters, at least one measure, the public sale of investments registered as limited partnerships (which is how most tax shelters are sold) shows enormous growth. According to Robert A. Stanger and Company, a New Jersey firm that tracks the shelter industry, sales totalled $6.2 billion in the first three quarters of 1983—70 percent higher than the comparable period of 1982. Mr. Stanger predicts that Americans will put $12 billion into shelters this year, 50 percent more than last year.

If the supply-side program did not cause the economy to recover, what did, and what kind of upswing will it be? It seems to me that the turnaround was triggered by the sharp declines in interest rates that began in summer 1982. As the cost of money came down the stock market revived. In turn, this enabled many people to purchase new cars and new homes and because automobiles and residential construction are the nation's two key industries, their revival sparked an upturn in many other sectors, leading to today's improved business climate.

Naturally, the Federal Reserve was instrumental in bringing interest rates down. Abandoning its earlier policy of tight money and rigid concentration on the monetary aggregates which was a part of the Administration's original economic program, the Federal Reserve eased money in order to end the liquidity crisis that developed when tight money clashed with the mammoth budget deficits that resulted from the tax cuts.

To their credit, many of the supply-siders recognized fairly early that the mixture of tight money and a loose fiscal policy could only be a prescription for disaster and began recommending that the Federal Reserve change its policy. However, when pressed, they would not say that they were calling for the Federal Reserve to ease money, thus risking a new round of inflation. Rather, they disguised this by claiming that all they wanted the Federal Reserve to do was to "stabilize prices and exchange rates." When asked whether a relaxed grip on money by the Fed would cause more inflation, a prominent member of Congress said last year: "It isn't a question of relaxing the Fed's grip on money. It is not a question of looseness or tightness. It is a question of stabilizing the value, the quality, of the currency." Since he and others were looking at prices of gold and other commodities that were falling during this time, however, the net effect of their recommendation was the same: They wanted the Fed to be more liberal in providing funds to the economy.

. . . Interest Rates May Rise

Our economic recovery of today, therefore, exists not because of supply-side economics—but in spite of it. The upswing will last as long as the Federal Reserve is able to provide enough money to take care of the financing needs of the private sector in the wake of the continuing large demands for funds by the government without creating so much money and credit that a new round of inflation ensues. If the Federal Reserve means what it says when it indicates that it does not intend to allow a new round of inflation to develop, then it should be expected that some time in 1984 the needs of the private sector will clash with those of the public sector and interest rates will begin to climb.

At the moment, as I observed in the October Report, business borrowing requirements are fairly low. For most of this year business has been paying down short term debt with funds obtained in the bond or stock markets. In addition, the tremendous improvement in profitability has led to a surge in cash flow that appears to be more than equal to expenditure needs for operations, inventories and capital goods. Thus, the Treasury has room to borrow to finance its huge budget deficit without boosting interest rates. However, the funding out process, as this is called, will not last indefinitely and when it comes to a close, upward pressures on interest rates will resume unless the budget deficit is brought down quickly. Since the Administration and its economic supporters have lately tended to minimize the importance of budget deficits and their correlation with such factors as interest rates, and since attempts to introduce programs that would cut spending and raise tax revenues have constantly been defeated, it does not appear likely that the budget deficit will shrink appreciably over the near term.

If the supply-siders have any new ideas as to how Federal financing needs can be accomplished in a non-inflationary environment without crowding out the private sector, now is the time to make them public—not after the next elections. H

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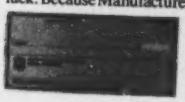

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Economic Report

Irwin L. Kellner
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DECEMBER 1983

Anniversaries

Before 1983 draws to a close, it might be worthwhile to note that it marked the tenth anniversary of three economic developments which had a major and lasting impact on the U.S. and most of the rest of the world. Ten years ago we experienced our first modern round of widespread and persistent double-digit inflation. Nineteen hundred seventy three also marked the adoption of generalized floating foreign exchange rates. Last but not least, the first oil "shock" occurred in 1973, in which oil prices were increased dramatically and oil supplies restricted. Looking back, these three developments seem intertwined—and maybe they were, to some extent. Nevertheless, each had its own distinct origins, as well as its own separate impact on the United States and others. Finally, each carries with it its own lessons for the future.

Double-Digit Inflation

Both the U.S. and other economies were building up to double-digit inflation prior to 1973. All the major industrial countries entered simultaneously into an expansion in 1972. In the second half of that year, real GNP rose at an annual rate of six percent in the seven largest OECD countries (Canada, France, Germany, Italy, Japan the United Kingdom and, of course, the United States). The growth rate in these countries increased even further—to nearly nine percent—in the first half of 1973. Not surprisingly, the rapid increase in production among so many countries was accompanied by an unprecedented explosion in world prices of industrial raw materials. Excluding fuels, prices of non-food industrial materials rose 2.5 times between early 1972 and early 1974.

Foods were no slouch, either. In 1972 the Soviet Union reported an extremely poor grain crop. This caused the USSR to purchase an enormous quantity of American grain at remarkably low prices. Crop failures occurred in other countries, and even in the United States food and feed grain output fell in 1972. The volume of U.S. grain exports increased dramatically between 1971 and 1973, and, combined with 1972's poor harvest, resulted in a sharp drawdown of grain stocks. The export price of American wheat more than tripled while the price of corn more than doubled. The food situation was further aggravated by the mysterious but well-publicized disappearance of the anchovies, a key source of protein feed, from their usual location off the coast of Peru. The sizable reduction in the anchovy catch put upward price pressures on soybeans—an alternate source of protein. Compounding all of this was the fact that the grain deals with Russia tied up the nation's railroads and port facilities, thereby restricting the movement of other goods, leading to temporary shortages and rises in their prices.

Thus 1973 was marked by a steady escalation in the rate of inflation. Starting at about four percent at the turn of the year, the three-month rate of rise in consumer prices rose steadily, breaking through the double-digit barrier by October 1973, with an inflation pace of 12 percent. Looked at on a three-month basis, the rise in consumer prices remained at a double-digit annual rate until early 1975, when, in the wake of what was until then the worst recession of the postwar era, the rate of price increases began to slow. This lasted until early 1976. Then, with the recession a year behind them, both labor and management began to ask for and became more tolerant of higher wages and higher prices. Once again inflation crept steadily upward and by early 1979 it was back into double-digits, running at an even higher rate than in 1973-74. It took a change in Federal Reserve operating tactics, as well as the most severe recession in the postwar era by many criteria (Economic Report—September 1983) to knock inflation down for the count.

Thus, ten years after double-digit inflation first surfaced, the rate of inflation has slowed dramatically. In the U.S., prices in 1983 went up by the smallest annual percentage in over 15 years. The rise in other indus-

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trialized countries was the least in over ten years. However, fears of a new round of inflation die hard. People may not be buying precious metals, Persian rugs, art or real estate the way they did four years ago. But the level of interest rates compared with the current rate of inflation suggests that it will take more than just a year or two of slowing inflation to convince participants in the economic process that we have finally returned to an era of price stability.

Floating Foreign Exchange Rates

The foreign exchange markets were already in turmoil when the decision was made to adopt floating exchange rates in March 1973. The thinking at the time was that this would be temporary, allowing various built-up pressures to be vented, and then there would be a return to a regime of par values. However, the inflation that overtook the world economy during this time made such a return difficult. It was compounded by the jump in oil prices in 1973 and the worldwide recession that developed in its wake. By early 1976 the combination of these shocks and the elapse of time had reconciled even the most ardent exponents of "fixed but adjustable par values" to the acceptance of a system of floating exchange rates.

To be sure, floating exchange rates had their supporters, too. Proponents claimed that, first of all, currency speculation and the resulting international monetary crises would be dramatically reduced, since the actual exchange rate would be dictated by the markets—not by governments. Second, advocates of floating rates asserted that, as a byproduct, balance of payments problems would be ironed out. Finally, the combination of the two would contribute to exchange rate stability without government intervention. These claims clearly proved to be exaggerated—although not because of floating exchange rates, per se. For example, while monetary crises, such as were common in the closing days of fixed exchange rates, have largely been avoided, in their place has appeared day-to-day currency volatility, spawning persistent distortions in exchange rates, generating a mood of uncertainty that may have injured world trade and discouraged cross-border investment. This is because each country continued to pursue its own narrow economic policy objectives, thereby causing differences in the value of currencies. It is obvious that floating exchange rates have not been able to impose the necessary discipline on different countries to force them to coordinate their economic policies.

On the other hand, the ballooning balance of payments deficits of a number of countries cannot be entirely attributed to floating exchange rates. For when the oil crisis struck, it led to something never before seen on the international scene: the running of persistent and expanding deficits in the external payments balances of a growing number of countries, in response to higher oil bills. Not only would this have occurred in the absence of floating exchange rates, it probably would have caused any system of fixed exchange rates to break down, anyway.

If there is a flaw in the floating exchange rate system, it is the underlying assumption that the markets will value currencies in such a way as to equalize terms of trade between most countries. In other words—even making allowances for different economic policies which result in different rates of inflation, floating exchange rates should take these into account and revalue or devalue currencies against one another in order that some semblance of equilibrium in trade can be maintained. In reality, this did not occur—at least insofar as it pertains to the dollar.

As you know, recent movements of the dollar seem to trace largely to interest rates, which are higher in the U.S., adjusting for inflation, than in virtually any other country. These high U.S. interest rates, relative to foreign rates, increase the demand for dollar assets, which, in turn, drives up the dollar exchange rate. In turn, this cuts into the ability of U.S. businessmen to sell goods overseas while enhancing prospects for the sale of imported merchandise here. Money flows out of the United States in response to the ensuing trade deficit—but returns, attracted by interest rate differentials.

Another problem not anticipated by advocates of floating exchange rates is the apparent inability of prices of imported merchandise to reflect changes in exchange rates. This is not to say that when the dollar fell, prices of imported merchandise were not marked up: they were. However, it seems that for many imported consumer goods sold in the United States, prices do not fall when the exchange rate of their country of origin declines. Since the end of 1980, the dollar has advanced by over 40 percent on a trade-weighted basis, yet import prices have fallen by only five percent. Part of this, of course, reflects higher prices abroad—but most seems to trace to an unwillingness of manufacturers, wholesalers, and retailers to reflect the lower exchange rates in U.S. selling prices.

To avoid creating further distortions, several steps should be taken. First, the United States must reduce its level of inflation-adjusted interest rates compared with other countries. The way to do this is through policies that will lead to a marked reduction in the

budget deficit, since it is fears of the impact of huge deficits that are causing the markets to keep real interest rates so high. Second, there needs to be a coordination of economic policies among the major trading partners of the Free World. Only in this way, can we establish the fundamentals for dampening swings in currency values.

If these two recommendations are implemented, we might consider some modification of the floating exchange rate system. Initially central banks could dip their toes in the water by intervening to dampen daily and weekly movements in exchange values. Ultimately, we might be able to move toward a new system that provides both stability and flexibility. Whether it is fixed but adjustable exchange rates, or floating rates with target zones is not important. What does matter is that the international monetary system do a better job of valuing currencies, promoting trade and capital flows than it is doing now.

The Oil Shock

A lot has been written about the price and availability of oil in the past ten years—not surprising, in view of the tenfold price increase that has occurred during this time. A lot has been blamed on the jump in oil prices—including double-digit rates of inflation and interest and the two worst recessions since the Great Depression of the 1930s. The rapid runup in the price of oil forced radical changes in the way Americans live and the way business operates, changing fortunes of whole industries and entire regions. Products or areas that were heavy users of energy fell into disfavor while those that used less energy or promoted energy conservation rose to the top.

Meanwhile, the financial markets were turned upside down. First there was the biggest outflow of money in history to pay for higher priced oil, then the biggest inflow as the Organization of Petroleum Exporting Countries (OPEC) sent these funds into U.S. banks, then the biggest lending program in history as the banks "recycled" these OPEC deposits to those consumers, companies, and countries who were faced with a sudden need to pay higher oil bills.

Starting in 1973, and continuing through the early part of this decade, each meeting of the OPEC countries was monitored nervously by the consuming countries to see what increase in price and/or cutback in output would result next. Conservation got underway as consumers, business and governments sought to reduce their dependence on imported oil in particular and energy in general. In response to the second oil shock of 1978-79, President Carter in June 1979, initiated the phase-out of crude oil price controls—a process completed by President Reagan in January 1981. The turnaround in the nation's energy situation since then has been nothing short of dramatic. From a level in spot markets exceeding $42 per barrel in 1980 and early 1981, oil prices subsequently tumbled more than $14, ultimately forcing OPEC to announce the first price reduction in its history. And the question on everyone's mind as the oil ministers met recently in Geneva was not whether they would raise oil prices—but whether they could hold them at present levels or if they would have to announce another decline.

Besides price-induced conservation, decontrol of U.S. oil prices has resulted in a stabilization of U.S. crude oil production in the lower 48 states since 1980, after it fell nonstop during the previous nine years. Thanks to smaller, more fuel-efficient automobiles, better home insulation and extensive capital investments by business in energy-saving equipment, the relationship between energy use and economic growth has been significantly altered over these past ten years. For a solid half-century prior to 1973, each one percent growth in GNP required a one percent increase in energy. Since then, that ratio has fallen to about one to six—meaning that each one percent rise in energy consumption can now support a six percent rise in GNP.

Not suprisingly, we are using less petroleum today than we did ten years ago. Indeed, the industrial world is using less oil today than in the deep recession year of 1975. What is more, no matter what happens to the price of oil from here on out, these trends are unlikely to be reversed. This is because of several factors. For one thing, the automakers must manufacture cars which are much more fuel efficient today than their predecessors of 1973. By law, the corporate average fuel economy for each manufacturer's fleet sold in the U.S. in 1984 must be 27 miles per gallon. There was no such requirement in 1973; the average new car did well if it got ten miles per gallon in that year. Since 1973, many buildings have either been constructed or retrofitted with energy efficiency uppermost in mind; these will not be abandoned if oil prices go lower. Neither will homeowners rip out their insulation or remove their energy-saving thermostats should oil prices fall significantly. About the only thing that might happen if oil prices were to drop further would be that the switch to other sources of energy might slow.

With their share of market nearly cut in two, the OPEC nations have taught the world—and themselves—one important lesson: the law of supply and demand still works. H

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